Comments by Stakeholders on Proposed Department Legislation for State Unemployment Tax Avoidance (SUTA) Dumping And Professional Employer's Organizations (PEOs)

The Employment Security Department (ESD) conducted two stakeholder meetings on June 28 and 29, 2005, seeking input from stakeholders on two separate proposals for the 2006 legislative session. The U.S. Congress passed a federal law in August 2004 requiring states to enact conforming legislation by January 2006. While our state's Title 50 addresses some parts of new federal law, some parts are not addressed. We are proposing that draft language be combined into one chapter of Title 50.

The following is a list of questions posed during the stakeholder meetings and comments provided:

State Unemployment Tax Avoidance (SUTA)

- **What constitutes "meaningful civil and criminal penalties?" Is the current language in RCW 50.12.220 (1)(C) and Chapter 50.36 RCW strong enough to meet federal requirements of meaningful penalties for both the employer evading their tax rate, and the business or person found to be promoting evasion of the predecessor/successor provisions in state law?**

  - Ms. McHenry with Administaff – a professional employee organization: I'm not speaking for the industry …but, I think as we reviewed it in-house it seemed to be consistent with something we could support and something we though was sufficient for criminal and civil penalties. We thought the Department of Labor (DOL) guidance was very fair.
  - Mr. Tucker with the National Association of Professional Employer Organizations (NAPEOs): We have also supported that. As a matter of fact, in my conversations with Jerry Hildbrandt with DOL, generally he thought was done in Washington was enough to certainly deem Washington State in compliance with the federal act. The penalty provisions were not something that he pointed to as something that needed to be "beefed up." I think what is on the books in Washington is similar to what many other states have done.
  - Ms. Smith – National Employment Law Project (NEPL): I think the issue in Washington State is more about the duration of the penalties. Our state law goes for a year or so and the federal recommendation is a "four-year penalty." And, I think the majority of states have followed the federal approach. Given the numbers of states finding tax avoidance in cases that they have reviewed, I believe the four-year penalty seems more appropriate.
  - Unknown speaker: The agency has the flexibility discretion in the tax penalty. What standard is appropriate for the statute?
  - Mr. Johnson – Organized Labor: From the labor perspective, we would like to see the duration resemble the federal recommendation. In 2003 when the Senate Bill 6097 came into being, one of the few pieces discussed was SUTA dumping.

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We did come to some agreement then. But, the federal issue didn't pass. So we're kind of working ahead of the federal curve. The original proposal was that the quarter, in which SUTA dumping was found, the employer would get the penalty and then the four subsequent quarters as well. Then the issue came up that we could not bridge two tax years, so then it all got collapsed into one year. I think that's all moot at this point given the federal recommendations that the duration is a significant deterrent.

- Ms. Bren – ESD – Our current statutes do not really address the person recommending the evasion scheme. Should we address this?
- Mr. Johnson – Washington State Labor Council (WSLC): Even though there are no civil penalties for that person, there are criminal penalties.
- Ms. Bren – ESD: The federal law is not clear on the person recommending SUTA dumping, just the person doing it. There are no civil penalties then. We can increase the rate on the person if we find it. But, if they are out-of-state, then we cannot really do anything about it.
- Ms. Smith – NELP:
  - With regard to criminal penalties, Washington should consider stronger criminal penalties, since under current law, the harshest penalty that an employer can face, and this is for a "willful" failure to pay taxes, is for a gross misdemeanor. Washington's system should more closely resemble the federal guidance.
  - With regard to civil penalties, Washington penalty structure differs from the federal guidance. Washington imposes a ten percent or $250 penalty for late reports. RCW 50.12.220(1)(a). This penalty will likely be nominal for most employers and the "late report" may not cover many SUTA dumping situations. Washington also imposes a penalty of ten times the contributions underpaid if an employer misrepresents its payroll. RCW 50.12.220(1)(b). However, this penalty is aimed at employers who drop workers from their payrolls, and probably does not reach employers who SUTA dump.
  - The only penalties in Washington law that seem to specifically apply to SUTA dumping are in RCW 50.12.220(1)(c) and (2). These apply to SUTA dumping itself and to late contributions, and impose penalties of the top tax rate plus two percent for one year, and a graduated percentage of taxes underpaid that reaches 20 percent at the third month, respectively. In most SUTA dumping cases, neither of these will likely be equivalent to the penalties suggested by DOL guidance (the maximum tax rate for four years, plus two percent in the case that an employer has already reached the maximum). Sixteen of the 26 other states studied by NELP have adopted the DOL suggestion. It is clear that only extremely tough penalties will deter SUTA dumping.

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- A related issue concerns penalties on non-employers. In this, we believe that the DOL suggested penalty of $5,000 is inadequate. We recommend that Washington State impose strict penalties on non-employers that violate the law as it does on employers. Given the amount of underpayment of taxes that is represented by SUTA dumping schemes that have thus far been uncovered by states, $5,000 is clearly not sufficient to deter tax advisors to encourage companies to dump their payroll taxes.

- **In RCW 50.29.220 (1) and/or RCW 50.36.02 how should the term "knowingly" be defined in statute as it is used to describe violating and attempting to violate state law related to SUTA dumping?**
  - Ms. McHenry - with Administaff: For purposes of consistency, because we want the federal act to have a national impact, the definition as advocated by DOL would probably be helpful not just to the state bout probably to employers who operate in several different states.
  - Ms. Smith – NELP: For the sake of clarity and both internal consistency and consistence with the federal SUTA dumping language, the term "knowingly" should be defined in the general definitional section for RCW Title 50, or in RCW 50.12, 50.20, and 50.36, and the standard in 50.36.020 should be changed from "willfully" to knowingly. DOL's guidance indicates that the "knowingly" test is the minimum standard that state law must contain in order to meet the requirements of federal law. State must assure that their tests are at least as broad as the "knowingly" standard in statute. The term and definition included in HR 3463, that "knowingly" includes "having actual knowledge of or acting with deliberate ignorance of or reckless disregard for the prohibition involved," would result in more internal consistency in the state law and compliance with the federal law.

- **Is state law clear enough in Chapter 50.29 RCW that experience will not be transferred if a person acquires an existing business for the sole purpose of obtaining that business's lower tax rate? In the cases the buyer ceases the activity of the purchased business and starts a new business activity at the lower tax rate.**
  - Ms. Smith – NELP: No. The current state law does not address situations where either a "person" or an "employer" acquires an existing business for the sole purpose of obtaining that business' lower tax rate. In our review of the DOL guidance, we have criticized the language that allows new employers who acquire businesses solely to obtain a lower rate to get the "new employer" rate. This means that in many states, the worst thing that can happen to a new employer who cheats is the same that happens to a law-abiding new employer. Vermont is the only state of which we are aware that effectively penalizes persons caught buying an existing unemployment account to start a new business under that lower tax

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rate. In Vermont, the non-employer acquiring the existing firm suffers a higher penalty than the new employer rate. Under H0071, such businesses are taxed at the highest rate until they have been in business long enough for accurate calculation of their experience rating.

- Mr. Johnson – WSLC: There was a specific provision in 6097 that raised the new employer tax rates…to 15 percent above the industry average. If a construction company buys a flower shop that had a one percent rate, then 15 percent would be tacked on top of the one percent. No, I do not believe this is a strong enough deterrent.
- Mr. Gonzales – UI Compensation Manager for the Boeing Company: Require transfer of experience from a closed or inactive account to the new or active account or successor operation when any one or more members of the ownership, management, or family* of the old business ownership or management participates in the ownership or management of the new business or successor operation.
  And, require transfer of experience in proportion to the workforce transferred from one business to another, in businesses with common ownership, management or family ownership or management, when the transferred workforce in a calendar year is 20 percent or greater. Recalculate the Tax Rate and Contributions due for the previous year attributable to the workforce transferred.
  *Add a definition of family – family as used in this section shall mean: parent, spouse, son, daughter, brother or sister.
  Add a question to the master application – Have you or any member of the ownership, management or member of the family of the ownership or management of the new business ever participated, or currently participate, in the ownership or management of another business?
  Revise the "Business Change Form (EMS 5208C) for each item 7-10 and create a new "Transfer of Employees Form" to be sent to all contributing employers in January for the previous calendar year. This new form should ask:

  > Did your company transfer twenty percent (20%) or more of its employees to another business in calendar year (2005)? □ No, □ Yes.
  > If yes, please give the percent of employees transferred and the name of the business the employees were transferred to and the ES reference number.
  > Percent of employees transferred:___%. Business Name: _____ES Reference #_____
  >
  > I, the undersigned, declare under the penalties of perjury, that I am the authorized representative of the company authorized to submit this information and that the answers contained, including any accompanying information, have been examined by me and that the matters and things set

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forth are true, correct and complete. Further, this information is submitted with the full knowledge that there are penalties prescribed by law for any employing unit or officer or agent of an employing unit or any other person who makes a false statement or representation, knowing it to be false, or who knowingly fails to disclose a material fact to avoid or reduce any contributions or other payments required from an employing unit under the Employment Security Act..

Signature Required_____, Telephone No._____, Date_____
Form Prepared By (Please Print) _____, Title, _____, Date_____
Please complete and return this form by January 31.

- **Should state law define employees as operating assets of a company? Our current emergency rules *WACV 912-300-050) include employees as operating assets. Federal law and DOL guidance require this provision, but states have the right to define the scope of this requirement.**
  - Ms. McHenry with Administaff: In a lot of provisions it give the department the discretion to make a decision as to whether or not SUTA dumping has actually occurred. Couldn't you just have a provision that says depending on each set of facts or circumstances each occurrence would be considered on a case-by-case basis?
  - Ms. Smith – NELP: Probably. The whole point of the SUTA dumping Prevention Act is to avoid tax rate manipulation that occurs when a business transfers its employees. It should somehow make clear that a partial transfer of employees is a transfer within the successorship provisions of the law. The state could avoid the pitfalls associated with a transfer of a small number of employees by covering only transfers of "substantial" number of employees, and decide on a case-by-case basis which transfers appear suspect. In its guidance, DOL suggested language that states can employ. UIPL 30-04 Q&A 5, and Change 1, 1-2 Question. In its language on "substantially common" ownership, DOL suggests that "substantial" can mean less than half. UIPL 30-04, Change 1, 1-3 Question.

Other questions or comments on SUTA Dumping?:

- Mr. Tucker – NAPEO: Jerry Hildebrandt spoke at our legislative council at our NAPEO legal legislative conference. When he did his presentation, in his roundup of states in the "okay" column, Washington State was included.
- Mr. Johnson – WSLC: Do you have any data on the number of transfers? Have you taken a look over the last year or two on the number of companies that have been SUTA dumping? Is there any way to do a sampling to get some sense of the

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issue? I am not suggesting that you set a number threshold, because that's hard. But to show us what extent this level of abuse is occurring.

Professional Employer Organizations (PEOs) and/or Employee Leasing Industry
The second proposal would provide guidelines for the department to work with the PEO and/or Employee Leasing industry. Currently state law does not address how these types of businesses should be treated for Washington State UI taxes purposes.

- **Should PEOs be handled the same way for Unemployment Insurance as they currently are handled by the state's Department of Labor and Industries for Industrial Insurance? The two agencies share information and both have found it is difficult to track experience when there is a client/PEO arrangement.**
  - Ms. Smith – NELP: Yes. It appears that under current law a transfer of employees from a work site business to a PEO is covered under RCW 50.29.062, and that the PEO is required to at least combine its experience with that of the acquired business.
    However, the Unemployment Insurance system is an experience-rated system, where employers who lay off workers are intended to see a bump in their tax rate. When employers essentially "sell" their employees to a PEO, and then "buy" them back under the legal fiction that they are the employees of the PEO, but still retain the ability to hire and fire them, the purpose of the system is defeated.
    States are likely losing millions of dollars of lawfully-owed taxes by allowing experience rates to be diluted by combining high-rate employers with low-rate employers, all considered the "employees" of the PEO. According to NAPEO, thirteen states, including Alaska, Connecticut, Delaware, Iowa, Kentucky, Louisiana, Massachusetts, Mississippi, Nebraska, Pennsylvania, Rhode Island, South Carolina and Vermont, consider the client rate as the appropriate UI rate for those working for a PEO. Other states have considered legislation to require either client-level reporting by PEOs, or that transfers to PEOs will be considered SUTA dumping. These include Arkansas, Michigan, Minnesota, New Jersey, North Dakota, and Wyoming.
    Were the state to require the use of the client rate for UI purposes, it would be more consistent with the goals of the experience-rated system, and address any SUTA dumping issues created by transfer of employees to PEOs.
  - Mr. Thorsen – Human Resources Novations a PEO: One issue is when both agencies found it difficult to track experience. I do not know if that was intended to mean difficult tracking clients. But, it's not an experience issue.
  - Mr. Heaton: Pay Plus Benefits:

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Comments on June 28: Even without the PEO arrangements, several years ago, the two agencies tried to come up with a unified system of some kind so they could trade information. And, in reality, they found out whether there is a PEO or a non-PEO that the agencies still could not make everything reconcile. The two agencies require reporting numbers that are totally incompatible. So the chances that your department and Labor and Industries will ever be able to reconcile is very slim.
For example: Hours worked. Labor and Industries only reports workers' compensation on hour worked. However, with your department, you have to record some hours that are not worked. You can never reconcile hours.
Also, your department has a wage base. Wage base has nothing to do with Labor and Industries.
So, I think we need to find better issues to worry about than the fact the two agencies cannot reconcile. Because you've tried it and you simply cannot reconcile. That pilot project was abandoned.
It is an administrative burden that would actually take money away from the state.
Comments on June 29: I believe that for the industry and for the state both that reporting UI under a single number is the most efficient because of the data that we send to both the Department of Labor and Industries and UI is based on different amounts. If we want to work towards a resolution on how to reconcile that (these systems), I believe that there is a better method than suddenly splitting out all of these different small business clients into different accounts.
A sub-account is established when a client company signs an agreement with a PEO or a leasing company. The sub-account is a sub-account of a client's account so that the current risk classification and "mod" factors are carried forward.
However, the major differences on what is reported to the state is that individual employee names are not reported to Labor and Industries, which they are to Employment Security. And, workers' compensation is based on hours worked, and with UI, it's gross wages. The types of hours that are reported are different. And, even the wages that are submitted are substantially different because you only submit the amount of wages earned under the risk classification of hours worked.
The way the systems are now, you can never have reconciliation between the two whether there is a PEO or not. In fact, four or five years ago the legislature actually enacted a temporary testing to see if they could ever get a reconciliation so that one agency could, in fact, see if things were consistent. They simply could not make it happen because the types of numbers that are supplied to both agencies. The only way that could work is if both agencies change their entire system now of reporting.

- Mr. Tucker – (NAPEO): I think Mr. Thorsen and Mr. Heaton did a good job of talking about the distinction between UI and workers compensation and why we

need to talk about those separately. You cannot look at these programs in the same light.

- Mr. Johnson – WSLC: Mr. Heaton is correct. There are different requirements for each agency. But for PEOs they do it for Labor and Industries but not for Employment Security.

- **How should the state address the transfer of experience for the PEO and for the client businesses entering or leaving a PEO arrangement?**
  - Mr. Gonzales – Boeing Company: Assign leasing entities (professional employer organizations) a separate employer account for each client and require the employee leasing businesses to keep separate records and submit separate quarterly unemployment tax and wage reports for each client.
  - Ms. Smith – NELP: These questions appear identical. If the state elects only to require client-level reporting by PEOs, rather than that the work site employer retains the experience rating, it will not solve the problem of the dumping of employees into a PEO in order to achieve a lower tax rate. Nor will it solve the question of the integrity of an experience-rated system when employers are allowed to share experience ratings among industries. However, reporting of number of employees, wages earned and industry in which the work is done would give the department some idea of the size of the PEO industry, the industries that are using PEOs, and the loss in revenue it is suffering. This provision might be difficult to enforce, depending on the utility of the DOL software to identify transfers that have not been reported.
  - Mr. Thoresen – Human Resource Novations: We prefer the way we are currently reporting, which is reporting at the PEO level. It facilitates a number of things in terms of reporting to the state under one tax ID number for all of the employees, all of the wages. Claims cone in under one number, our number. So we are handling the reporting of those claims.
    As far as notifying the department what clients we have, we would not have a problem with that. But, it would create a little more of an administrative burden. And, quite frankly, if we are reporting at the client level then we are not reporting officers if they haven't elected, which we are now. We are not starting over the wage base if we are taking on a client in the middle of the year…which we are doing now. If the client goes out of business we are not reporting them anymore, which we are. It would be reported under a particular rate.
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- **What type of notification would be appropriate when a client enters or leaves a relationship with a PEO?**

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- Mr. Thoresen - Human Resource Novations: If a client went out of business, they do not report to you anymore because they don't have any more employees. But, if they were under a single group number, we are continuing to pay on their past wages until it runs out over the next four years or whatever that term is.
  If an employer leaves, a client leaves the relationship and goes out on their own again, what we see more of is leaving a PEO and going to another PEO. If they leave them and want to go out on their own, I would suggest they get the new employer rate, whatever that is.
  Clients have been with us for ten years or more. This isn't an in-and-out kind of proposition with a client. It's intended to be a long-term relationship and it usually is. The industry across the county has a very high client-retention rate. So that's my recommendation. When a client leaves to go out on their own again, just give them the new employer rate.
  If a client comes into a PEO and you would like to transfer their lower experience to us, then that is fine. You have the data. You can compare my rate and a lot of other rates. I think you are going to find it's kind of a non-issue.
  I think you would have too
- Mr. Heaton - Pay Plus Benefits: They've (the department) has done very well with us. We do notify our local Employment Security office in Kennewick. It's a courtesy, number one. It stops our client from getting a late report. Everyone knows right up front. We don't want any tax avoidance at all. We don't want confusion. We rarely take on a client that has a rate higher than ours.
  If we start talking about transferring rates, the next door that will be opened is talking about transferring the bases. Right now we think the state is doing very well because if they come with my company, they are going to get a higher rate and the bases starts over. We have the strongest anti-SUTA dumping system there is. Not only do we start the bases over, but also it's at a higher rate. And, if you start transferring rates then you are going to have bases. People are going to ask for that. And, that's one advantage, the way we've been doing it is that you don't have to worry about that.
- Mr. Tucker – (NAPEO): It's for those reasons that Mr. Thoresen and Mr. Heaton have just identified. The administrative efficiencies, the workforce management, the financial windfall, if you will, to the state. Clearly in the guidance sent out by DOL, it contemplates that the states can keep doing – handling PEO reporting the way that they have. That certainly is the trend. The PEO agency is recognized in approximately 28 or 29 states.
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- **How should the department handle the reporting of wages for the owners or corporate officers of a client company involved in a PEO arrangement?**

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- **Is registration of PEOs necessary or appropriate? National Association of Employer Organizations (NAPEO) has provided model language for a registration process. Is this something that Washington State wishes to implement?**
  - Mr. Tucker – NAPEO: It is one of our core missions from the national association level to pursue a compilation through a registration act that dovetails what is already working. This is one of those issues that is always encompassed within the comprehensive PEO act where there is a licensing act or registration act. When we start to drill down into the PEO business model the benefits are not just to UI, to workers' compensation, but we start talking about health benefits and retirement plans. Really it's a benefit to the state. Compliance goes way up form small businesses who just do not have the wherewithal, the knowledge, the expertise to do that.